

Message Text

PAGE 01 STATE 188504

12
ORIGIN INR-07

INFO OCT-01 EUR-12 EA-07 NEA-10 ISO-00 EB-07 AID-05

CIAE-00 COME-00 FRB-03 NSAE-00 USIA-06 TRSE-00 XMB-02

OPIC-03 SP-02 CIEP-01 LAB-04 SIL-01 OMB-01 NSC-05

SS-15 STR-04 CEA-01 /097 R

DRAFTED BY INR/REC:CMONROE
APPROVED BY INR/DDR:MPACKMAN
INR/RNA:GHARRIS
INR/REC:LJKENNON
NEA/EGY:BROWN
NEA/RA:DMORRISON
EB/IFD/ODF:FTHOMAS

----- 070519

R 300031Z JUL 76
FM SECSTATE WASHDC
TO ALL NEAR EASTERN AND SOUTH ASIAN DIPLOMATIC POSTS
AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY COPENHAGEN
AMCONSUL FRANKFURT
AMEMBASSY THE HAGUE
AMEMBASSY LISBON
AMEMBASSY LONDON
AMEMBASSY MADRID
AMCONSUL MUNICH
USMISSION OECD PARIS
AMEMBASSY OSLO
AMEMBASSY OTTAWA
AMEMBASSY PARIS
AMEMBASSY ROME
AMEMBASSY STOCKHOLM
AMEMBASSY VIENNA
AMCONSUL ZURICH
AMEMBASSY BELGRADE
AMEMBASSY MOSCOW
CONFIDENTIAL

PAGE 02 STATE 188504

AMCONSUL ALEXANDRIA
AMCONSUL JERUSALEM
USLO PEKING
AMEMBASSY TOKYO

XMT AMEMBASSY BEIRUT
AMEMBASSY COLOMBO
AMEMBASSY DACCA
AMEMBASSY ISLAMABAD
AMEMBASSY KABUL
AMEMBASSY KATHMANDU

C O N F I D E N T I A L STATE 188504

E.O. 11652: GDS

TAGS: EG, ECON

SUBJECT: THE EGYPTIAN ECONOMY

1. FOLLOWING IS TEXT OF INR REPORT NO. 536, "THE EGYPTIAN ECONOMY IN 1976: THE LEGACY OF CONFRONTATION," DATED JULY 28, 1976.

2. BEGIN SUMMARY: EGYPT'S CONTINUING MILITARY CONFRONTATION WITH ISRAEL HAS SEVERELY CONSTRAINED EGYPTIAN ECONOMIC DEVELOPMENT. FOR TWO DECADES THE DEFENSE EFFORT, WHICH HAS CONSUMED AS MUCH AS 20 PERCENT OF EGYPTIAN GNP, HAS PREEMPTED RESOURCES THAT MIGHT OTHERWISE HAVE GONE INTO ECONOMIC DEVELOPMENT.

3. NASSER'S ATTEMPT TO CRASH-INDUSTRIALIZE AND CREATE A WELFARE STATE FURTHER STRAINED EGYPTIAN FINANCIAL RESOURCES. AS A RESULT, INDUSTRIAL GROWTH BECAME STAGNANT AND EXPORTS INCREASED ONLY marginally. IMPORTS, BY CONTRAST, SPIRALED UPWARD DUE TO LARGE PURCHASES OF INDUSTRIAL AND MILITARY EQUIPMENT. CAPITAL INFLOWS WERE INSUFFICIENT TO COVER CURRENT ACCOUNT DEFICITS, AND EGYPT RESORTED TO PASSING THE BAT AND COMMERCIAL

BORROWING TO FINANCE THE BALANCE, RATHER THAN CUT BACK ON PLANNED LEVELS OF EXPENDITURE.
CONFIDENTIAL

PAGE 03 STATE 188504

4. EGYPTIAN DEFICIT SPENDING OVER THE PAST FEW YEARS HAS BEEN MADE POSSIBLE BY HUGE INFUSIONS OF FUNDS, PRINCIPALLY FROM ARAB STATES. SINCE THE OCTOBER 1973 WAR, EGYPT HAS RECEIVED OVER A BILLION DOLLARS ANNUALLY IN GRANT AID FROM ITS OIL-RICH NEIGHBORS. WESTERN INDUSTRIALIZED COUNTRIES HAVE ALSO CONTRIBUTED, BUT ON A LOWER SCALE.

5. EARLIER THIS YEAR, HOWEVER, DONOR NATIONS INDICATED THEIR UNWILLINGNESS TO CONTINUE TO FUND EGYPT'S DEFICITS UNLESS EGYPTIAN OFFICIALS INTRODUCED FAR-REACHING ECONOMIC REFORMS AIMED AT ELIMINATING BASIC IMBALANCES WITHIN THE ECONOMY. UNDER CONSIDERABLE PRESSURE FROM ARAB

LEADERS, THE EGYPTIAN GOVERNMENT AGREED TO SEEK IMF COUNSEL AND, AFTER A SERIES OF EXTENDED NEGOTIATIONS, ANNOUNCED THAT AGREEMENT HAD BEEN REACHED "IN PRINCIPLE" BETWEEN THE EGYPTIAN GOVERNMENT AND THE IMF ON A REFORM PACKAGE.

6. EGYPTIAN OFFICIALS WOULD LIKE TO REACH AGREEMENT WITH THE IMF THOUGH THEY FIND THE PROCESS OF REFORM POLITICALLY PAINFUL. IF THE EGYPTIAN GOVERNMENT CAN INTRODUCE THE AGREED-UPON REFORMS, EGYPT WILL QUALIFY FOR IMF STANDBY FUNDING, WHICH COULD TOTAL AS MUCH AS DOLS 300 MILLION OVER THE NEXT THREE YEARS. OF GREATER SIGNIFICANCE, PERHAPS, IS THE SYMBOLIC IMPORTANCE OF RECEIVING THE IMF SEAL OF APPROVAL, WHICH THE EGYPTIANS BELIEVE WILL SPARK AN INCREASE IN BILATERAL COMMITMENTS FOR ASSISTANCE FROM OECD AND OTHER COUNTRIES. IN THE NEAR TERM, THE EGYPTIAN ECONOMY WILL REMAIN HEAVILY DEPENDENT ON OFFICIAL TRANSFERS, TO FINANCE BALANCE OF PAYMENTS DEFICITS AND SPUR THE GROWTH OF THE EXPORT SECTOR. GROWING PROSPERITY IN WESTERN MARKETS WILL ALSO HELP EGYPT'S FOREIGN EXCHANGE EARNINGS, BUT THESE WILL CONTINUE, FOR THE FORESEEABLE FUTURE, TO BE MUCH LESS THAN EGYPTIAN IMPORTS. END SUMMARY.

7. AFTER MORE THAN 20 YEARS OF EGYPTIAN-ISRAELI CONFRONTATION, THE EGYPTIAN ECONOMY CONTINUES TO BE STRAINED AND DISTORTED BY THE COMPETING DEMANDS OF DEFENSE AND CONFIDENTIAL

PAGE 04 STATE 188504

A DEVELOPMENT EFFORT WHICH EARLIER EMBODIED THE INTENT OF A SOCIALIST WELFARE STATE. THE HEAVY DEFENSE EFFORT HAS AFFECTED ALMOST EVERY ASPECT OF ECONOMIC ACTIVITY, FROM THE NATURE OF DOMESTIC SPENDING TO THE CLIMATE FOR PRIVATE INVESTMENT AND TOURISM. OVER THE PAST DECADE, DEFENSE SPENDING HAS CONSUMED A PROGRESSIVELY GREATER

SHARE OF EGYPTIAN RESOURCES. IN 1974, DEFENSE EXPENDITURES TOOK 20 PERCENT OF GNP (WHICH WAS STEADILY RISING AT A RATE OF 6-8 PERCENT ANNUALLY), UP FROM 15 PERCENT OF GNP THREE YEARS EARLIER.

8. EGYPT HAS DERIVED LIMITED BENEFITS FROM ITS STATUS AS A CONFRONTATION STATE WHICH HAVE PARTIALLY OFFSET THE DRAIN ON EGYPTIAN FINANCIAL RESOURCES. ONE SUCH BENEFIT HAS BEEN THE RECEIPT OF SUBSIDY PAYMENTS SINCE 1967 FROM ARAB NEIGHBORS WHO WERE NOT DIRECTLY INVOLVED IN THE WAR EFFORT. THESE PAYMENTS HAVE BEEN SMALL RELATIVE TO EGYPT'S TOTAL NEEDS, AND NOW ACCOUNT FOR ONLY A FRACTION OF ARAB AID.

9. THE INCREASE IN DEFENSE SPENDING HAS OCCURRED LARGELY AT THE EXPENSE OF CIVILIAN INVESTMENT. OUTLAYS FOR INVEST-

MENT, WHICH FORMED UP TO 18 PERCENT OF GNP PRIOR TO THE 1967 WAR, HAVE DECLINED CONSIDERABLY AND NOW ACCOUNT FOR ONLY 10 TO 12 PERCENT OF GNP. SHORTAGES OF INVESTMENT RESOURCES AND FOREIGN EXCHANGE HAVE CONTRIBUTED TO A CAPITAL STOCK DETERIORATION AND STAGNATION IN INDUSTRIAL GROWTH.

10. THE NASSER PERIOD:

11. THE LEGACIES OF THE NASSER ERA (1954-70) HAVE ALSO PROVED TO BE A BARRIER TO EGYPTIAN ECONOMIC GROWTH. TWO WARS WITH ISRAEL AND EGYPTIAN INVOLVEMENT IN THE YEMEN CIVIL WAR PLACED HEAVY DEMANDS ON EGYPTIAN RESOURCES. IN ADDITION TO MILITARY SPENDING, THE JUNE 1967 WAR WITH ISRAEL RESULTED IN THE LOSS OF THE SINAI OIL FIELDS AND CUT OFF SUEZ CANAL REVENUES OF OVER DOLS 200 MILLION ANNUALLY.

CONFIDENTIAL

PAGE 05 STATE 188504

12. MOREOVER, NASSER'S CRASH INDUSTRIALIZATION AND WELFARE PROGRAMS OF THE 1960'S MET WITH LITTLE SUCCESS. INFLOWS OF FOREIGN EXCHANGE WERE INSUFFICIENT TO FINANCE A VOLUME OF IMPORTS CONSISTENT WITH THE REQUIREMENTS OF AN EXPANDING ECONOMY, AND A HIGH LEVEL OF FOREIGN DEBT WAS INCURRED. IMPORTS OF INVESTMENT GOODS WERE INADEQUATE, MANY MAJOR PROJECTS WERE INAPPROPRIATE, AND RAW MATERIAL SHORTAGES OFTEN PREVENTED THE UTILIZATION OF EXISTING CAPACITY. INDUSTRIALIZATION EFFORTS FAILED TO PROMOTE GROWTH IN EXPORTS OR IMPORT SUBSTITUTION AND LEFT THE COUNTRY WITH HUGE ANNUAL CURRENT ACCOUNT DEFICITS AND A HIGH LEVEL OF FOREIGN INDEBTEDNESS.

13. RETURN TO ECONOMIC LIBERALISM:

14. THE DETERIORATION OF THE ECONOMY AND GROWING SOCIAL DISCONTENT CONVINCED PRESIDENT SADAT OF THE NEED TO INTRODUCE A FRESH ECONOMIC STRATEGY. FOLLOWING THE OCTOBER 1973 WAR WITH ISRAEL, SADAT ANNOUNCED PLANS FOR A MAJOR REDIRECTION OF THE ECONOMY, BASED ON A RETURN TO ECONOMIC LIBERALISM AND RAPPROCHEMENT WITH THE WEST.

15. SADAT'S POSTWAR OBJECTIVES, OUTLINED IN HIS OCTOBER WORKING PAPER, CALLED FOR IMPROVED ECONOMIC RELATIONS WITH BOTH WESTERN AND ARAB COUNTRIES IN AN EFFORT TO ENCOURAGE THE INFLOW OF FOREIGN INVESTMENT AND TECHNOLOGY FROM ALL SOURCES (THE "OPEN DOOR" POLICY). THIS DOCUMENT WAS SUBMITTED TO THE PEOPLE'S ASSEMBLY AND APPROVED BY POPULAR REFERENDUM IN MAY 1974.

16. IN THE SUBSEQUENT 18 MONTHS, THE EGYPTIAN GOVERNMENT INTRODUCED A SERIES OF NEW MEASURES INTENDED TO LEAD TO

GREATER LIBERALIZATION OF THE ECONOMY AND IMPROVE PROSPECTS FOR DEVELOPMENT OF THE PRIVATE SECTOR.

(A)--NEW BANKING AND FOREIGN TRADE LAWS ELIMINATED SOME OF THE RESTRICTIONS ON PRIVATE BUSINESS ACTIVITIES.

(B)--A NEW FOREIGN INVESTMENT LAW CONTINUED GUARANTEES AGAINST NATIONALIZATION.

CONFIDENTIAL

PAGE 06 STATE 188504

(C)--THE GOVERNMENT WIDENED THE PARALLEL EXCHANGE MARKET--CREATED IN LATE 1973--TO ENCOURAGE THE FLOW OF FOREIGN EXCHANGE TO MEET PRIVATE SECTOR NEEDS.

(D)--THE GOVERNMENT ALSO REDUCED CERTAIN CONSUMPTION SUBSIDIES AND EASED SOME PRICE CONTROLS SO THAT MARKET FORCES INCREASINGLY WOULD DETERMINE THE ALLOCATION OF RESOURCES.

17. FAILURE OF THE "OPEN DOOR":

18. THE NEW ECONOMIC STRATEGY, HOWEVER, FAILED TO ACHIEVE ECONOMIC RECOVERY. A MAJOR CONSTRAINT PROVED TO BE THE BUREAUCRACY PUT TOGETHER DURING THE NASSER REGIME. ITS PERSONNEL WERE TOO SOCIALIST-ORIENTED TO COPE WITH FREE MARKET INSTITUTIONS OR CARRY OUT THE CHANGES REQUIRED BY LIBERALIZATION. DESPITE NEW COMMITMENTS OF FOREIGN AID AND GREATER INTEREST BY FOREIGN PRIVATE INVESTORS, INFLOWS OF FOREIGN EXCHANGE WERE NOT SUFFICIENT TO COVER THE HIGH LEVEL OF CAPITAL GOODS IMPORTS REQUIRED FOR ECONOMIC RECONSTRUCTION, MILITARY IMPORTS, GREATER VOLUMES OF FOOD IMPORTS AT INCREASINGLY HIGHER PRICES, AND THE SERVICING OF HEAVY EXTERNAL DEBT OBLIGATIONS.

19. IN 1973, IMPORTS OF DOLS 1.66 BILLION EXCEEDED EXPORTS OF DOLS 1.0 BILLION, LEAVING A TRADE DEFICIT OF OVER DOLS 600 MILLION. NET TRANSFERS, MOSTLY FROM ARAB GOVERNMENTS, WERE MORE THAN SUFFICIENT TO COVER THE TRADE DEFICIT, GIVING EGYPT A SLIGHT SURPLUS IN ITS BALANCE OF PAYMENTS FOR THE YEAR. BY 1975, IMPORTS HAD JUMPED TO DOLS 4.17 BILLION WHILE EXPORTS HAD GROWN TO ONLY DOLS 1.67 BILLION, INCREASING THE DEFICIT TO DOLS 2.5 BILLION.

20. THE CURRENT YEAR OFFERS LITTLE PROSPECT FOR IMPROVEMENT. EGYPTIAN BALANCE OF PAYMENTS PROJECTIONS SHOW THE IMPORT LEVEL AT DOLS 5.6 BILLION AND THE EXPORT LEVEL AT DOLS 1.8 BILLION, LEAVING A RECORD TRADE DEFICIT OF DOLS 3.8 BILLION. GIVEN CURRENT FOREIGN EXCHANGE SHORTAGES, HOWEVER, IT IS UNLIKELY THAT IMPORTS WILL IN FACT REACH THEIR PROJECTED VALUE. MORE LIKELY, THE GOVERNMENT WILL ACT TO HOLD THEM NEAR THE 1975 LEVEL.

CONFIDENTIAL

PAGE 07 STATE 188504

21. DEBT:

22. EGYPTIAN FOREIGN INDEBTEDNESS HAS INCREASED DRAMATICALLY IN RECENT YEARS AS THE GOVERNMENT HAS TURNED TO COMMERCIAL CREDIT IN ORDER TO MAINTAIN A HIGH LEVEL OF IMPORTS. SINCE 1973, MEDIUM- AND LONG-TERM DEBT (NON-MILITARY) HAS INCREASED BY 100 PERCENT, REACHING DOLS 5.2 BILLION AT THE END OF 1975. EGYPT HAS INCREASED ITS RELIANCE ON THE COMMERCIAL SHORT-TERM MARKET TO AN EVEN GREATER EXTENT. SINCE 1973, AUTHORIZED SHORT-TERM CREDITS HAVE INCREASED BY 150 PERCENT, REACHING DOLS 2.6 BILLION AT THE END OF 1975.

23. IN 1976, EGYPT FACES REPAYMENT OF AT LEAST LE (RPT 6E) 840 MILLION (DOLS 2.1 BILLION AT THE OFFICIAL RATE). OF THIS AMOUNT, 6E (RPTE) 364 MILLION (DOLS 930 MILLION) IS SCHEDULED FOR REPAYMENT OF SHORT-TERM DEBT. THE EGYPTIAN GOVERNMENT IS TRYING TO CONVERT A LARGE PART OF THIS INTO MEDIUM-TERM COMMERCIAL DEBT THROUGH A CONSORTIUM. WHAT THE EGYPTIANS CANNOT CONVERT THEY WILL ATTEMPT TO ROLL-OVER, WHICH IS THEIR CURRENT PRACTICE, AND PAY ONLY THE INTEREST, WHICH IS RUNNING AS HIGH AS 20 PERCENT. ALSO SCHEDULED TO BE REPAYED IS (RPT (E) 263 MILLION (DOLS 650 MILLION) IN OFFICIAL DEPOSITS, MOST OF WHICH ARE SHORT-TERM CAPITAL TRANSFERS BY OIL-RICH GULF STATES. IT IS WIDELY BELIEVED THAT THE DONORS DO NOT REALLY EXPECT TO BE REPAYED IN THE NEAR TERM AND THAT THESE OBLIGATIONS WILL CONTINUE TO BE CARRIED FORWARD WITH ONLY INTEREST BEING PAID.

CONFIDENTIAL

24. IF THESE ACCOUNTS ARE NOT REPAYED, AND THE SHORT-TERM DEBT IS EITHER CONVERTED OR ROLLED OVER, DEBT REPAYMENT COULD RUN AS LOW AS LE (RPT 6E) 300 MILLION (DOLS 770 MILLION). DEBT SERVICE ON MEDIUM- AND LONG-TERM CREDITS RAN ABOUT DOLS 1.0 BILLION LAST YEAR, EQUIVALENT TO ABOUT 60 PERCENT OF EXPORT EARNINGS, AN ENORMOUSLY HIGH DEBT SERVICE RATIO.

25. DEPENDENCE ON ARAB DOLE:

CONFIDENTIAL

PAGE 08 STATE 188504

26. SINCE THE 1973 WAR, THE EGYPTIAN GOVERNMENT HAS BEEN FORTUNATE IN RECEIVING LARGE CASH GRANTS FROM ARAB OIL PRODUCERS AND IRAN WHICH HAVE COVERED MUCH OF EGYPT'S EXTERNAL FINANCING GAP. IN 1974, OIL-PRODUCING COUNTRIES SUPPLIED EGYPT WITH GRANTS TOTALING DOLS 1.25 BILLION TO HELP OFFSET A TRADE DEFICIT OF DOLS 1.75 BILLION. IN

1975, OIL PRODUCERS PROVIDED ANOTHER DOLS 1.28 BILLION IN GRANTS (IN ADDITION TO SOME DOLS 800 MILLION IN LOANS) AGAINST A TRADE DEFICIT THAT WAS DOLS 1 BILLION LARGER THAN THE YEAR BEFORE.

27. RECENTLY, HOWEVER, ARAB DONORS HAVE BECOME LESS WILLING TO CONTINUE TO BAIL OUT THE ECONOMY WITHOUT EVIDENCE THAT THE EGYPTIANS ARE MAKING AT LEAST SOME ATTEMPT TO GET THEIR HOUSE IN ORDER. WHEN SADAT VISITED THE ARABIAN PENINSULA IN FEBRUARY 1976, ARAB LEADERS, PARTICULARLY SAUDI LEADERS, EXPRESSED INCREASING ALARM OVER THE LACK OF SOUND ECONOMIC PLANNING BY THE EGYPTIAN GOVERNMENT, AND THEY INDICATED THAT THERE WERE LIMITS TO WHAT THEY WOULD PROVIDE TO HELP EGYPT MEET ITS CURRENT FINANCIAL CRISIS.

28. SADAT DID OBTAIN DOLS 725 MILLION IN CASH GRANTS FROM THE PENINSULA ARAB COUNTRIES, BUT THE AMOUNT WAS ONLY A SMALL FRACTION OF WHAT HE HAD ASKED FOR. THE ONLY LONG-RANGE COMMITMENT THAT THE EGYPTIAN LEADER RECEIVED WAS A PROMISE BY GULF RULERS TO CONSIDER THE ESTABLISHMENT OF A FUND TO SUPPORT DEVELOPMENT PROJECTS IN EGYPT. GULF LEADERS MET IN CAIRO ON JULY 17 TO INITIAL AN AGREEMENT FOR A GULF ORGANIZATION FOR DEVELOPMENT IN EGYPT, WHICH IS EXPECTED TO PROVIDE DOLS 400-450 MILLION ANNUALLY TO FINANCE NEW DEVELOPMENT PROJECTS AND BALANCE OF PAYMENTS DEFICITS DURING THE 1976-80 FIVE-YEAR PLAN.

29. OTHER DONOR ASSISTANCE:

30. THE EGYPTIAN GOVERNMENT HAS BEEN LOOKING INCREASINGLY TOWARD THE WEST FOR ADDITIONAL POLITICAL AND ECONOMIC SUPPORT. THIS REORIENTATION BECAME QUITE PRONOUNCED WHEN

CONFIDENTIAL

PAGE 09 STATE 188504

EGYPT UNILATERALLY ABROGATED THE 1971 SOVIET-EGYPTIAN FRIENDSHIP TREATY IN MARCH OF THIS YEAR. IN 1975, EGYPT RECEIVED COMMITMENTS FOR FINANCIAL ASSISTANCE (GRANTS AND LOANS) FROM WESTERN SOURCES TOTALING DOLS 700 MILLION: DOLS 350 MILLION FROM THE UNITED STATES; DOLS 150 MILLION FROM JAPAN; AND DOLS 200 MILLION FROM WEST EUROPEAN COUNTRIES.

31. THE EGYPTIANS ALSO HAVE COMMITMENTS FROM US GOVERNMENT OFFICIALS TO HELP EGYPT SECURE FINANCIAL ASSISTANCE IN 1976 FROM IRAN AND THE OECD COUNTRIES. THE US CONTRIBUTION TO THE EGYPTIAN RELIEF EFFORT TOTALS DOLS 950 MILLION AND CONSISTS OF A LARGE PACKAGE OF CASH GRANTS, PL-480 ASSISTANCE, AND PROJECT LOANS. IN ADDITION, IN THE PAST FEW MONTHS US GOVERNMENT OFFICIALS HAVE MADE REPEATED REPRESENTATIONS TO THE GOVERNMENTS OF IRAN, JAPAN, FRANCE,

AND THE FRG TO REQUEST THAT THEY GIVE ADDITIONAL FINANCIAL ASSISTANCE TO EGYPT THIS YEAR.

32. ON HIS OWN INITIATIVE, PRESIDENT SADAT DECIDED TO VISIT WESTERN EUROPE THIS SPRING IN AN EFFORT TO INCREASE COMMITMENTS FOR ECONOMIC ASSISTANCE TO EGYPT WHILE GENERATING SUPPORT FOR HIS MIDDLE EAST PEACE POLICY. HE SUCCEEDED IN SECURING ADDITIONAL COMMITMENTS OF EXPORT CREDITS, GUARANTEES, AND PROJECT LOANS TOTALING DOLS 448.4 MILLION: DOLS 158.4 MILLION FROM THE FRG; DOLS 40 MILLION FROM ITALY; AND DOLS 240 MILLION FROM AUSTRIA.

33. ECONOMIC REFORM:

34. DONOR NATIONS HAVE EXERTED CONSIDERABLE PRESSURE ON THE EGYPTIAN GOVERNMENT TO INTRODUCE REFORMS TO ELIMINATE SOME OF THE EXTERNAL AND INTERNAL IMBALANCES WITHIN THE ECONOMY, THEREBY LOWERING EGYPT'S REQUIREMENTS FOR OUTSIDE ASSISTANCE IN THE YEARS TO COME. THESE NATIONS HAVE ALSO PRESSED EGYPT TO ACCEPT SOME IMF OR IBRD GUIDANCE IN ECONOMIC POLICY. IN THE PAST, THE EGYPTIAN GOVERNMENT HAD REJECTED THE IDEA OF INTERNATIONAL SUPERVISION, EQUATING IT WITH THE POLITICALLY UNACCEPTABLE APPEARANCE OF ECONOMIC TUTELAGE. HOWEVER, DONORS' THREATS TO WITHHOLD FURTHER PLEDGES OF ASSISTANCE WERE SUFFICIENT TO CONFIDENTIAL

PAGE 10 STATE 188504

FORCE EGYPTIAN LEADERS TO RECONSIDER THEIR POSITION, THOUGH RELUCTANTLY, PARTICULARLY SINCE THEY SAW NO OTHER ACCEPTABLE MEANS OF MANAGING THEIR DEFICITS.

35. EARLY THIS SPRING, THE EGYPTIAN GOVERNMENT ENTERED INTO NEGOTIATIONS WITH IMF OFFICIALS FOR A REFORM PACKAGE THAT, IF FULLY IMPLEMENTED, WOULD QUALIFY EGYPT FOR IMF FUNDING UNDER THE STANDBY AGREEMENT. THE MAJOR ISSUES

APPEAR TO BE THREE:

(A)--THE EXCHANGE RATE STRUCTURE;

(B)--SUBSIDIES; AND

(C)--THE LEVELS OF GOVERNMENT SPENDING AND PRIVATE SECTOR IMPORTS.

36. THE IMF WANTS EGYPT TO REVISE ITS DUAL EXCHANGE RATE SYSTEM AND MOVE OVER TIME TO A UNITARY RATE. THE FUND HAS WORKED OUT AN ARRANGEMENT WITH EGYPT FOR A NEW "COMMERCIAL MARKET RATE" WHICH WOULD REPLACE THE PARALLEL RATE. THE COMMERCIAL RATE OF (RPTE) 1.0 DOLS 1.43 WOULD BE SLIGHTLY LOWER THAN THE PRESENT PARALLEL RATE OF (RPTE) 1.0 DOLS 1.46, AND CONSIDERABLY LOWER THAN THE

OFFICIAL RATE OF LE (RPT LE) 1.0 DOLS 2.56. MOVING ALL TRANSACTIONS TO THE NEW COMMERCIAL RATE WOULD AMOUNT TO A LARGE DEVALUATION WITH CONSEQUENT ONE-TIME SUBSTANTIAL INFLATIONARY EFFECT. FOR THE PRESENT, HOWEVER, ONLY CERTAIN CATEGORIES OF GOODS WILL BE TRANSFERRED TO THE NEW RATE; MOST OF THE BASIC CONSUMER COMMODITIES WILL CONTINUE TO BE IMPORTED AT THE OFFICIAL RATE.

37. ANOTHER IMPORTANT ELEMENT OF THE EXCHANGE REFORM IS THE ELIMINATION OF SOME OF THE CONTROLS ON FOREIGN EXCHANGE TRANSACTIONS. BANKS, FOR EXAMPLE, ARE TO BE PERMITTED TO DEAL IN FOREIGN CURRENCIES WITHOUT CENTRAL BANK CONTROLS. EXPORTERS, OTHER ENTITIES, AND PUBLIC SECTOR COMPANIES AND CORPORATIONS ARE TO BE ALLOWED TO RETAIN FOREIGN EXCHANGE PROFITS STEMMING FROM INVISIBLES, THOUGH FOREIGN CURRENCY REVENUES FROM EXPORTS WILL REVERT TO THE EGYPTIAN GOVERN-
CONFIDENTIAL

PAGE 11 STATE 188504

MENT IN MOST CASES. THESE CHANGES WERE CONFIRMED IN MID-JULY BY THE PASSAGE OF A NEW FOREIGN EXCHANGE TRANSACTIONS LAW BY THE PEOPLE'S ASSEMBLY.

38. THE IMF ALSO OBJECTS TO THE EGYPTIAN SYSTEM OF SUBSIDIZING ITEMS OF MASS CONSUMPTION, A PRACTICE INTRODUCED DURING THE NASSER PERIOD AS PART OF HIS WELFARE PROGRAM. THIS SYSTEM HAS BECOME PARTICULARLY BURDENSOME ON THE BUDGET IN THE LAST FEW YEARS AND HAS GREATLY ENLARGED THE DEFICIT. SUBSIDIES COST THE GOVERNMENT 6E (RPTE) 493 MILLION (DOLS 1.26 BILLION AT THE OFFICIAL RATE) IN 1975, UP ALMOST 50 PERCENT OVER THE PREVIOUS YEAR AND ABOUT 15 PERCENT OF GDP. FOR 1976, THE EGYPTIANS HAD BUDGETEDE (RPTE) 640 MILLION (DOLS 1.64 BILLION) FOR SUBSIDIES. THE IMF HAS CRITICIZED THESE EXPENDITURES AS HAVING CONTRIBUTED TO RESOURCE MISALLOCATION AND FUNDAMENTAL DISEQUILIBRIUM WITHIN THE ECONOMY.

CONFIDENTIAL

39. WHILE IMF OFFICIALS FAVOR THE ABOLITION OF THIS SYSTEM ENTIRELY, THEY RECOGNIZE THAT POLITICALLY THIS CANNOT BE DONE ALL AT ONCE. THE EGYPTIAN GOVERNMENT HAS INDICATED THAT IT WILL REDUCE THE AMOUNT ORIGINALLY BUDGETED THIS YEAR FOR SUBSIDIES BY AT LEAST LE (RPTLE) 100 MILLION, WHICH IS BELIEVED TO BE ACCEPTABLE TO THE IMF.

40. IMF OFFICIALS ARE PARTICULARLY CONCERNED ABOUT THE HIGH LEVEL OF GOVERNMENT SPENDING FOR PROJECTS WITH A HEAVY IMPORT CONTENT. THE IMF WANTS EGYPT TO REDUCE PLANNED PUBLIC SECTOR EXPENDITURES FOR SUCH PROJECTS BY AT LEAST 6E (RPTE) 100 MILLION THIS YEAR AND TO CONTROL IMPORTS TO THE EXTENT NECESSARY TO KEEP THEM NEAR THEIR 1975 LEVELS.

41. IN MARCH, IMF OFFICIALS INDICATED THAT THEY HAD REACHED AGREEMENT "IN PRINCIPLE" WITH THE EGYPTIAN GOVERNMENT ON A REFORM PACKAGE WHICH, WHEN FULLY IMPLEMENTED, WOULD QUALIFY EGYPT FOR IMF FUNDING. SINCE THAT TIME, HOWEVER, IMF OFFICIALS AND THE EGYPTIAN GOVERNMENT HAVE BEEN UNABLE TO REACH A FINAL AGREEMENT, OWING LARGELY TO EGYPTIAN FOOT-DRAGGING ON CERTAIN REFORM MEASURES WHICH WERE CONFIDENTIAL

PAGE 12 STATE 188504

FOUND TO BE POLITICALLY DIFFICULT TO CARRY OUT. WHILE THE EGYPTIAN GOVERNMENT HAS MOVED IN THE AGREED-UPON DIRECTION IN SOME AREAS--REDUCING SHORT-TERM CREDITS, INTRODUCING NEW TAX LEGISLATION, CONVERTING VALUATION FOR CUSTOMS AT THE PARALLEL RATE--INTERNAL OPPOSITION HAS PREVENTED THE IMPLEMENTATION OF CERTAIN OTHER REFORM MEASURES. THE EGYPTIAN GOVERNMENT HAS BEEN UNABLE TO RESOLVE THE ISSUES OF THE SIZE OF PUBLIC SECTOR IMPORTS, THE SIZE OF THE REDUCTION IN SUBSIDIES, AND WHICH GOODS TO TRANSFER FROM THE OFFICIAL TO THE COMMERCIAL RATE.

42. OUTLOOK:

43. CURRENT PROSPECTS FOR THE EGYPTIAN ECONOMY SUGGEST LITTLE IMPROVEMENT IN THE FINANCIAL PICTURE IN THE NEAR TERM. EGYPT IS LIKELY TO CONTINUE TO RUN HUGE CURRENT ACCOUNT DEFICITS ONLY PARTIALLY OFFSET BY CAPITAL INFLOWS, LEAVING A NET FINANCING GAP OF WELL OVER DOLS 1.0 BILLION ANNUALLY FOR THE FORESEEABLE FUTURE.

44. THERE WOULD APPEAR, HOWEVER, TO BE PROSPECTS FOR IMPROVEMENT OVER THE LONG RUN. EGYPT'S POSITION AS A NET EXPORTER OF OIL SHOULD CONTINUE TO INCREASE AS OIL PRODUCTION IS EXPECTED TO REACH 1 MILLION BARRELS PER DAY BY 1980. THIS COULD BRING IN FOREIGN EXCHANGE REVENUES OF DOLS 1.0 BILLION OR MORE. EGYPT WILL ALSO BENEFIT FROM THE OPENING OF THE SUMED PIPELINE, SCHEDULED TO BEGIN

CONFIDENTIAL
OPERATIONS IN DECEMBER 1976. SUEZ CANAL REVENUES SHOULD REACH DOLS 500 MILLION THIS YEAR AND ARE EXPECTED TO RISE TO DOLS 800 MILLION OR MORE BY 1980. WORKER REMITTANCES FROM EGYPTIANS WORKING IN OTHER PARTS OF THE GULF ARE EXPECTED TO CLIMB SHARPLY, WHICH SHOULD ALSO HELP TRIM THE FINANCIAL GAP.

45. THE ARAB MILITARY INDUSTRIES ORGANIZATION, BASED IN EGYPT, HAS CONSIDERABLE POTENTIAL FOR ATTRACTING INVESTMENT AND COULD GENERATE SUBSTANTIAL EXPORT REVENUES IN THE FUTURE.

CONFIDENTIAL

PAGE 13 STATE 188504

46. THE BILATERAL RELAXATION OF TENSIONS WITH ISRAEL AND THE EGYPTIAN GOVERNMENT'S PEACE OBJECTIVES SHOULD BENEFIT THE ECONOMY ON TWO COUNTS: A GREATER INFLUX OF TOURISTS CAN BE EXPECTED, AND MORE OF THE COUNTRY'S RESOURCES CAN BE DIVERTED FROM THE MILITARY EFFORT INTO ECONOMIC DEVELOPMENT.

47. EGYPT'S ABILITY TO MAXIMIZE ITS FOREIGN EXCHANGE EARNINGS POTENTIAL IN THE FUTURE DEPENDS ON THE ABSENCE OF MILITARY CONFLICT AND ITS ABILITY TO DEAL WITH ITS ECONOMIC PROBLEMS AT THE PRESENT TIME. THIS IS CONTINGENT ON EGYPT'S ABILITY TO OBTAIN CURRENT MULTILATERAL AND BILATERAL FINANCIAL COMMITMENTS AND KEEP IMPORTS UNDER CONTROL. EGYPT MAY NOT BE ABLE TO RELY ON THE FOREIGN DOLE INDEFINITELY. THIS INCREASES THE PRESSURE ON EGYPT TO REACH SOME ACCORD WITH THE IMF FOR ECONOMIC REFORMS, WHICH SHOULD REDUCE EGYPT'S DEPENDENCE ON EXTERNAL ASSISTANCE OVER THE LONG RUN.

48. THUS FAR, THE IMF "CARROT" OF DOLS 300 MILLION IN FINANCIAL ASSISTANCE HAS NOT BEEN SUFFICIENT TO LEAD SADAT TO TAKE REFORM MEASURES WHICH HE CONSIDERS TO BE POLITICALLY RISKY. HE RECOGNIZES THAT HE HAS VERY LITTLE ROOM TO MANEUVER: TOO RAPID A REFORM WOULD HIT LOWEST INCOME GROUPS THE HARDEST AT A TIME WHEN PRESSURES FOR AN IMPROVED STANDARD OF LIVING ARE RISING. THERE IS GREAT CONCERN OVER ANY REFORM ACTION WHICH MIGHT LEAD TO AN INCREASE IN THE COST OF LIVING. THE GOVERNMENT IS UNWILLING AT THIS TIME TO RISK MEASURES WHICH COULD LEAD TO DOMESTIC INSTABILITY AND THREATEN THE SURVIVAL OF THE CURRENT LEADERSHIP. THESE CIRCUMSTANCES PROBABLY ACCOUNT FOR THE EGYPTIAN GOVERNMENT'S RECENT INDICATION TO THE IMF THAT IT DID NOT INTEND TO IMPLEMENT FURTHER REFORMS UNTIL LATER IN THE YEAR, PRESUMABLY AFTER THE OCTOBER ELECTIONS.

49. SADAT IS CAUGHT BETWEEN PRESSURES FROM DONORS AND CREDITORS TO TAKE POLITICALLY DIFFICULT ACTIONS IN THE NEAR

FUTURE AND THE EASIER COURSE OF TRYING TO MUDDLE THROUGH UNTIL PROSPECTIVE REVENUES MATERIALIZE. HE MAY HAVE DECIDED TO TAKE THE GAMBLE THAT THE OIL-RICH PENINSULA
CONFIDENTIAL

PAGE 14 STATE 188504

ARABS AND OTHERS WHO SUPPORT HIM POLITICALLY WILL CHOOSE TO SUPPORT HIM ECONOMICALLY, AND NOT RISK DOMESTIC UPHEAVAL WHICH MIGHT OUST HIM FROM POWER.

50. IN ANY CASE, SADAT STILL MUST FINANCE THE DOLS 1.0 BILLION DEFICIT ON THE BALANCE OF PAYMENTS WHICH REMAINS IN 1976. HIS ONLY PROSPECT FOR CLOSING THIS GAP AT

PRESENT IS THE NEW ARAB AID FUND. SUMS FROM THIS NEW
FUND MIGHT FILL AS MUCH AS HALF OF THIS GAP, WHICH SHOULD
BE SUFFICIENT TO HELP EGYPT GET BY UNTIL AFTER THE OCTOBER
ELECTIONS. AFTER THAT POINT, EGYPTIAN OFFICIALS MAY BE
WILLING TO RESUME NEGOTIATIONS WITH THE IMF ON THE IMPE-
MENTATION OF FURTHER REFORMS. KISSINGER

CONFIDENTIAL

<< END OF DOCUMENT >>

Message Attributes

Automatic Decaptioning: X
Capture Date: 15 SEP 1999
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: INTELLIGENCE ASSESSMENTS, ECONOMIC REPORTS
Control Number: n/a
Copy: SINGLE
Draft Date: 30 JUL 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: GolinoFR
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976STATE188504
Document Source: ADS
Document Unique ID: 00
Drafter: INR/REC:CMONROE
Enclosure: n/a
Executive Order: 11652 GDS
Errors: n/a
Film Number: D760294-0867
From: STATE
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t197607109/baaaepog.tel
Line Count: 603
Locator: TEXT ON-LINE, TEXT ON MICROFILM
Office: ORIGIN INR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 11
Previous Channel Indicators:
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: GolinoFR
Review Comment: n/a
Review Content Flags:
Review Date: 26 MAR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <26 MAR 2004 by greeneet>; APPROVED <29 MAR 2004 by GolinoFR>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: THE EGYPTIAN ECONOMY
TAGS: ECON, EG
To: ALL NEAR EASTERN AND SOUTH ASIAN DIPLOMATIC POSTS
BONN
BRUSSELS
COPENHAGEN
FRANKFURT
THE HAGUE

LISBON
LONDON
MADRID
MUNICH
OECD PARIS
OSLO
OTTAWA
PARIS
ROME
STOCKHOLM
VIENNA
ZURICH
BELGRADE
MOSCOW
ALEXANDRIA
JERUSALEM
PEKING
TOKYO
XMT BEIRUT
COLOMBO
DACCA
ISLAMABAD
KABUL
KATHMANDU

Type: TE

Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006